

## SECTION C - DESCRIPTION / SPECIFICATION / WORK STATEMENT

### I. Introduction

The USAID/Kosovo Mission is implementing a program called Kosovo Employment Generation (KEG). It is composed of two distinct but coordinated components: Kosovo Business Finance (KBF) and Kosovo Business Support (KBS).

The KBS component was contracted in September 2000 with Chemonics International Inc., 1133 20<sup>th</sup> Street NW, Suite 600, Washington, DC 20036 (Contract No. PCE-I-00-97-00015-00, T.O. 805). It addresses four areas: Direct support to SMEs with high potential for rapid growth and employment generation to establish or improve competency in key functional areas. Direct support to SMEs in financial distress with turnaround and crisis management measures/assistance Broad support to the business community through training programs, sector analyses, trade and investment linkages, and dissemination of performance improvement resources Development of a cadre of Kosovar consultants to leverage and sustain project activities.

This SOW addresses only the KBF component of the KEG program.

### II. Program Summary

The Kosovo Business Finance (KBF) Program will support the recovery and revitalization of small and medium enterprises (SMEs) in Kosovo by providing an SME credit facility and supporting the establishment of a full-service bank in Kosovo to mobilize deposits and provide other financial services to SMEs. The design of this program has emerged from a USAID funded assessment that concluded that there is insufficient credit available to support the recovery of Kosovar businesses and that this constitutes a critical constraint to economic recovery and employment growth. The **implementing partner** will have experience in the effective delivery of financial intermediation services to SMEs. The **purpose** of the activity is to use U.S. foreign assistance to establish a sustainable source of financing for small and medium enterprises and to establish a permanent indigenous financial institution in Kosovo to provide financial services and mobilize deposits. This activity will underpin broad-based economic growth to be generated through the SME sector and will create employment. The **program period and funding** is expected to be for three years, of which \$15MM will go for creation of a loan fund, up to \$5MM for capitalization and related financial support services of a full-service Kosovar bank, and the remaining will be provided for technical assistance to operate and oversee the loan fund.

### III. Background

The province of Kosovo, already suffering from a decade of discrimination and neglect, was further ravaged in 1999 by the Serb occupation and ethnic cleansing which culminated in the March-June NATO intervention. Kosovo is beginning to recover, bolstered by a large international presence and financial support, but damage to the people and the economy has been extensive and rebuilding will be long and arduous.

During the conflict, almost half the population of Kosovo fled their homes, almost half of the housing stock was damaged or destroyed, most medium and large businesses were idled, and significant damage was inflicted upon infrastructure and industrial capacity. Unemployment as reported per UNDP is massive and in excess of 50%. There is an urgent need to get people back to work and get businesses operating again, but the challenge of rebuilding Kosovo is immense.

Extensive and broad ranging efforts are underway by the international community in the areas of infrastructure and housing reconstruction, as well as to establish a sound macroeconomic policy environment and put in place a market-oriented commercial law framework necessary to support economic recovery. USAID/Kosovo is taking a lead role in this, providing support in the areas of establishing a macroeconomic policy framework, financial sector reform, and legal and regulatory reform.

Programs are also underway to support the rebuilding of the business sector. A number of small and micro lending programs have been established to respond to the need for credit for reconstruction inputs and working capital<sup>1</sup>. However, all of these programs are, to date, focussed on short-term lending to micro and small businesses, and loan disbursements to date have been quite small (under \$3MM in total). The World Bank is developing a longer-term lending program for small and medium businesses, which is scheduled to be in place by Fall 2000. Experience in Kosovo thus far indicates that significantly greater financial resources for on-lending can be mobilized from domestic savings than is likely to become available through the provision of donor resources. In this regard, the EBRD and KFW sponsored Micro Enterprise Bank (MEB), which is currently the only licensed banking institution in Kosovo, has mobilized well in excess of DEM 100 million in deposits in just 8 months of operation.

This program will employ a substantially different approach than that being undertaken by the World Bank. While both recognize the importance of lending to larger SMEs (loans in the 50K-500K DM range), the USAID program will differ in two key respects. First, it has the express purpose of building a sustainable business bank, which will not only provide credit, but will also undertake deposit mobilization and the recycling of those deposits as loans (significantly leveraging the initial seed loan funds) and provide critical banking services such as funds transfers and guarantees (L/Cs). Second, it will aggressively employ micro and SME loan analysis and administration techniques and processes that have proven successful in other transitional and developing economies.

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<sup>1</sup> No indigenous banks are currently operating in Kosovo. While several are expected to receive licenses in the next few months, it is not believed that they will be very active in credit intermediation.

An assessment was performed in June 2000 by a USAID sponsored team of finance and small business experts on the needs and demand for SME credit and support services as well as the current and projected supply thereof (and the expected impact of such support on private investment and employment generation). Based upon the conclusions reached, USAID is undertaking the KBF Program in order to provide a high-impact and sustainable source of short and medium term lending and other financial services to SMEs.

KBF will establish a loan fund and capitalize the development of a business bank targeted primarily towards serving the high-end of the SME market (10-250 employees)<sup>2</sup>. KBF will have three components: 1) a quick response loan fund to allow for rapid credit disbursement to creditworthy, privately-owned SMEs (to include marketing support to accelerate submission of loan requests); 2) the capitalization and start-up costs for a full-service, deposit gathering institution (a bank) that will i) mobilize deposits for re-lending purposes, and ii) once established, assume the portfolio of the quick response lending facility; and 3) technical assistance to develop the financial analysis and management capability of the bank staff to assure post-project sustainability.

**Enterprise Sector - Demand.** Reliable data on the current status of the enterprise sector is weak as a result of a significant gray economy and dislocations resulting from the 1999 conflict. In general, the sector is comprised of about 156 large (over 250 employees) enterprises (all of which are publicly owned and 58 of which are operating) and perhaps 18-20,000 privately-owned micro and SMEs, of which perhaps half are operating (about 5,000 firms have registered at UNMIK<sup>3</sup>). About half of active enterprises have less than 6 employees and are thus micro-enterprises. Extrapolating therefrom, there are currently about 5,000 SME firms operating in Kosovo. GDP is roughly estimated at \$1-1.3 billion. Private sector firms generate around \$750MM of revenues of which about 75% are SME produced, equating to average firm revenue in the SME sector of \$112,500.

Using assets as a measure of loan demand, average small firm (6-20 employees) fixed assets (excluding land and buildings) were 265K DM and average medium firm (21-100 employees) fixed assets were 835K DM. Inventory for small firms was 56K DM and medium firms was 212K DM. Assuming a five year replacement schedule (and 81% of managers responded that their equipment was over five years old), annual equipment acquisition costs and working capital requirements (assumed at 40% of inventory) would be:

	<u>Fixed Assets</u>	<u>Working Capital</u>
Small firms (6-20)	54K DM	22K DM
Medium firms (21-100)	167K DM	84K DM

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<sup>2</sup> This paper uses the World Bank assessment definition for business size of micro (1-5 employees), small (6-20) and medium (21-250).

<sup>3</sup> Data is taken from a World Bank sponsored assessment completed in March 2000. Around 17,000 enterprises were registered in 1998 of which 55% were operating in a continuous manner.

These numbers generally correlate with the estimates of local managers, who indicate that equipment in need of replacement or modernization is around 400K DM.

A breakdown of firm loan demand by loan size shows the following distribution:

<u>Loan Amount DM</u>	<u>Percent of Firms Surveyed</u>
Less than 20,000	20%
20,001 - 50,000	20%
50,000 - 100,000	21%
100,000 - 400,000	25%
Over 400,000	14%

The bulk of credit demand (60%) in the productive sector (i.e. non-trade sector) is for loans in excess of 50,000DM.

Finally, another approach to assessing credit demand is to look at historical trends in investment activity. The table below shows aggregate and average investment for the period 1997 to 1999 by firms surveyed:

**Investments by Firms Surveyed for the Period 1997-1999**

<b>Year</b>	<b>Total Amount Invested (DM)</b>	<b>Percentage of Firms Investing (%)</b>	<b>Average Investment (DM)</b>
1997	29,100,000	81	360,000
1998	22,500,000	68	330,000
1999	12,300,000	63	195,000

The average size of investment is in line with loan range mentioned above (and virtually all investments made during the period 1997 to 1999 were made by privately owned firms). This is further evidence that the credit demand in the DM 40,000 to 400,000 range is substantial and represents a realistic assessment by enterprises of their funding needs. In addition, of the firms surveyed were asked whether they anticipated applying for loans if funds were available, 100% replied in the affirmative. Most of the requests would be in the DM 50,000 and above range.

Given the results of this and other surveys it is apparent that i) demand for loan capital is critically needed to restart private sector enterprises, ii) the need is almost universally felt by enterprises of all sizes and regardless of sector, and iii) the aggregate demand in the productive sector alone is significant and sure to increase in the future as firms restart basic operations.

**Financial Sector - Supply.** The World Bank survey, confirmed by the USAID assessment, shows the dearth of credit as a key constraint to SME development. Only one bank (MEB) is currently in operation and is targeted at the micro and small level. A number of other lending programs have been established; however, disbursements to date have totaled less than \$2MM in aggregate, and these are targeted primarily at either micro or small businesses.

The USAID assessment team's work confirms the conclusions reported by the World Bank study. Interviews with local banks and analysis of available data show that current lending is at levels well below demand. The MEB, the only bank currently operating, lends on a very localized basis and only in the micro and small credit ranges. Other lending programs in aggregate total only DM4MM and again focus on micro and small sized credits. Any funds available to medium sized companies originate from non-banking sources. (Existing and proposed credit sources in Kosovo found in **Annex A.**)

The World Bank survey showed that of the 16 constraints to operating and expanding enterprises identified, by far the most significant (84% of responders) were the lack of financial resources and investment. In regard to financing constraints, the most severe constraint was deemed to be difficulty in obtaining long-term credit (noted as very severe) and the second most was difficulty in obtaining short-term credit (noted as major).

Finance Constraints to Kosovar SMEs					
Difficulty of obtaining long-term credit					
Difficulty of obtaining short-term credit					
Lack of supplier credit					
Lack of payment instruments (checks, drafts, etc.)					
Problems with financing transfers					
Level of interest rate					
Required guarantee too high					
Lack of leasing facility					
Paperwork and regulations					
Poor advice from banks					
Behavior of bank officials					
Degree of severity	1= None	2= minor	3= moderate	4= major	5= very severe

In short, the financial sector cannot at present adequately serve the needs of SMEs, either in terms of satisfying credit demand or meeting the need for commercial banking services.

- Loan demand is solid and unmet, with most SMEs needing credit in excess of 50K DM
- Most lending programs are targeted at the low end of the market - up to 40K
- 84% of the businesses surveyed said that access to credit was their overriding constraint in developing their full market potential
- The vast majority of business transactions are made in trade or cash barter, reflecting the lack of access to financing commercial activities
- Only 22% of enterprises had bank accounts (all abroad)
- Only 3% had outstanding loan balances
- A significant majority said that they could not meet current demand due to inadequate, outdated or damaged machinery

**Legal Constraints.** Under the leadership of UNMIK, and with substantial support from USAID and other donor agencies, major progress has been achieved in establishing a legal and regulatory environment for banks and other financial institutions in Kosovo and in setting up a public regulatory entity, the Banking and Payments Authority of Kosovo (BPK), to implement these laws and regulations. UNMIK is receiving intensive support from USAID in putting into place major building blocks for a market oriented commercial law framework in the property, contract and corporate law areas. However, it will likely require an extended period of time before institutional enforcement mechanisms are effectively in place to facilitate full implementation of these measures. The resulting uncertainty is reinforced by the current lack of consensus regarding ownership rights.

The lack of securely-determined property rights and laws to make contracts clearly enforceable greatly complicates the ability of lenders to make and enforce loan contracts through traditional guarantees or other means, especially considering the absence of property registries and multiple claims to certain properties, those in the state-owned or social property sectors in particular. This set of circumstances not only makes lending more risky but also requires techniques different from those used traditionally by commercial bankers.

**Agri-Business Credit.** Agriculture is a key sector in Kosovo with good prospects for near term recovery. Substantial progress has been realized in activating marketing channels for fertilizers and other agricultural inputs, and in building trade associations and supporting the development of agricultural processing and technical assistance for farmers. The USAID assessment team supports the conclusions reached in the IFDC Project Completion Report (May 31, 2000), which makes three important points:

1. There is already a growing group of agricultural input suppliers that will be demanding increasing amounts of credit to finance their activities (e.g., credit for inventories);
2. There are significant numbers of agricultural processors that will be demanding substantial amounts of credit to restart or expand their businesses (e.g., credit for equipment and working capital); and
3. Availability of credit from these marketing intermediaries may be among the best ways to increase access to credit for small and medium scale farmers on an effective and efficient basis, as compared to having banks and other financial intermediaries attempt to lend to them directly.

#### **IV. Strategic Objective**

This activity will support USAID/Kosovo's Strategic Objective 1.3 - Establishment of a Market-Oriented Economic Policy and Institutional Framework. The explicit focus of the program will be on stimulating employment and increasing private investment in the SME sector, thereby supporting the rapid and sustainable recovery of living standards for the Kosovar population. It will support the reconstruction of the private economy and provide the opportunity to build upon the entrepreneurial capabilities and informal trade and financial networks developed out of necessity by the Kosovar Albanians over the past decade.

#### **Participants/Program Components**

Implementation of this program may require an organization, a consortium of organizations and/or two different organizations which is/are USAID partners experienced in SME lending and financial sector institutional development in transitional and developing economies, as well as being qualified as a commercial bank prepared to establish a Kosovo banking operation and re-lend the deposits gathered.

The program will incorporate the following components: (1) expeditiously set up a quick response loan fund which would operate in accordance with market principles; (2) establish (capitalize and staff) and effectively operate a full service banking institution; (3) effectively integrate the quick response loan fund into the operation of the banking institution during the 3 year implementation period; and (4) provide for ongoing effective operation and sustainability of the banking operation (with maximum local participation) after the initial three year funding and implementation period and up to a minimum of three more years thereafter.

Technical and training services for the operation of the loan fund and the full service banking institution will be provided through a contract. Financial support for the establishment and operation of the quick response loan fund and the full service banking institution will be provided either through a cooperative agreement, endowment or contract. This will be either to the same Contractor (whether a single organization or consortium) or to an entirely different organization working as a partner with the Contractor in accordance with a comprehensive agreement design developed during the first 90 days of the program by the institutional Contractor. In this regard, two separate agreements may be negotiated - a contract for the technical and training services requested, and subsequently, another agreement for the financial services requested. This agreement will spell out in detail the financial service provision and fiduciary responsibilities of the recipient or contractor. The agreement will lay out the ongoing reporting and financial management duties and obligations of the recipient/contractor toward USAID after the initial three year funding and initial program implementation period expires, and for an additional period of at least three years thereafter. Such agreement will contain refund provisions regarding all funds granted for credit or reserve capital in the event the recipient fails to operate the bank during the initial and second three year period.

## **V. Scope of Work**

The implementing contractor shall undertake the following tasks during the first year of implementation:

Develop and implement a quick response loan fund: Establish and oversee a loan fund to support SME credit needs. This will be comprised of up to \$15 million in financial support for loanable funds as follows: (a) a \$3MM quick response tranche in year one to get loans moving until a full service business bank (capable of undertaking lending and deposits) is established and made functional. Such bank must be established no later than the end of year two; and (b) subsequent tranches in years two and three of up to \$9MM and \$3MM, respectively, to be managed through a loan window at the bank.

Provide technical assistance for staffing and managing the loan fund and provide training to Kosovar staff in credit, deposit mobilization and operations: Set up a loan production unit ("LPU") to be staffed by a team of expatriate/TCN commercial lenders and operations specialists and Kosovar staff. This unit will be charged with:

- establishing a lending operation - \$15MM over three years;

- loan origination and review of loan applications;
- approving creditworthy loan applications within the established lending criteria;
- assuring proper loan and collateral documentation;
- monitoring and supervising the loan portfolio; and
- training Kosovar staff (and potentially other SME service providers) in the areas of credit, loan administration and operations, with particular emphasis upon techniques for successful loan granting and administration in developing or transitional economies.

The unit will be guided by broad policies, terms and conditions determined by USAID. The Unit will make all lending decisions, although with a strong consultative relationship (and possibly co-approval) by USAID.

Consideration of loan requests will reflect the priorities of revitalizing businesses and generating employment and as such will give priority to (a) private and privatizing firms which offer high employment generation potential; (b) projects which, with minimal capital, help reactivate existing local productive potential; (c) firms which will utilize domestic inputs and have export potential. In all cases, however, lending decisions must first and foremost be based upon sound credit principles and the high likelihood of repayment. The LPU will include a loan origination function which will support Kosovar companies to prepare loan applications that will present an accurate representation of their current and prospective operations, their collateral positions and their business plan as necessary. This is needed to provide the LPU with clear, comprehensive, and systematically prepared loan requests. (It should be noted that the loan origination team will not be in any way separate from the lending function - nor will the loan origination function serve as advocate for the loan applicant. The sole purpose is to facilitate a rapid flow of adequately prepared loan packages to the LPU.)

The loan origination team will:

- In consultation with the LPU, prepare a format for provision of loan requests, including historical and projected financial information, description of operations, markets and management, company registration and incorporation data, collateral and other information as shall be required by the LPU;
- Undertake a rapid assessment of the Kosovo business sector in order to establish a list of prospective loan applicants;
- Contact prospective companies to explain the program;
- Support interested and qualifying companies to prepare business plans and loan requests; and
- As necessary, work with the LPU in the credit review process.

Provide USAID with a detailed design/proposal for establishment of a full service banking institution. This would include a business plan for the operation and staffing of the bank, a plan for the utilization of up to \$5 million in capitalization and related bank start-up costs to be provided by USAID to support the operation of the bank; a plan for full integration of the operation of the specialized loan window into the banking institution by the close of year two of the program;

and a plan for USAID's ongoing monitoring and oversight role in the operation of the banking institution after the close of the three year program.

Support capitalization and start-up of the full service business bank.

Support the effective establishment of the aforementioned full service business bank through:

- Guiding the formation, licensing, and operationalization of the bank;
- Fostering the development of the bank into a competitive commercial institution capable of competitively providing a full range of financial intermediation services; and
- Developing, to the maximum extent feasible, a partnering relationship with a local financial institution.

In summary, under the KBF Program up to \$15 million in financial support will be provided by contract, cooperative agreement or endowment for loanable funds to SME's which are expected to turnover as reflows following loan repayments. In addition up to \$5 million in financial support will be provided by cooperative agreement or endowment for capitalization of a banking institution in Kosovo. This would include the following elements: (1) the provision of funds to the banking institution to help it meet the minimum capitalization requirements of the Banking and Payments Authority of Kosovo (BPK); (2) the provision of funds to the banking institution to help it meet the additional loan provisioning requirements it will face because of the type of loan portfolio it will be expected to manage under the KBF Program; and (3) material costs (eg. building lease/refurbishment costs, equipment procurement costs) associated with establishment of a banking institution.

The provision of up to the \$5 million envisaged for bank capitalization and related start-up costs will likely be provided through a separate USAID cooperative agreement action. There is also the possibility that it could be implemented through a subgrant under the institutional contract. USAID will carefully review and assess the proposal for establishment of a commercial bank made by the institutional contractor before making a final determination on the optimal instrument for supporting the establishment of the banking institution.

In addition, the Contractor shall provide technical support to perform the following: (1) the staffing of a specialized credit line operation, including loan evaluation and administration specialists, and loan identification specialists; (2) the staffing of positions in the deposit mobilization, accounting, bank operations, and information technology areas required by the institutional contractor to support the set up and management of a banking institution and effectively train up local staff to assume operational and (eventually) management positions in that institution. The work of the staff in the accounting, bank operations, and information technology areas will be initiated during the establishment of and impact on the effective implementation of the specialized credit line also.

## **VI. Benchmarks and Tangible Results**

The contractor understands and agrees that achievement of the benchmarks and tangible results are the essence of this program agreement, and that USAID will judge contractor/recipient success based upon whether or not the benchmarks and tangible results are achieved. In the event that any benchmark or tangible result is not achieved or should it be realized that any of these are not achievable, then the contractor shall immediately advise USAID in writing and, in the next required report to USAID, provide a complete explanation of the circumstances relating thereto.

During the performance period, the contractor/recipient will set up and oversee an SME loan fund which will meet the disbursement targets stipulated, while ensuring high credit quality as determined by default, arrearage and loan classification criteria. Loan targets (and anticipated employment impact - assuming 5,000 DM in loans equates to one job created) are as follows:

**Year One**

- 200 loans disbursed with average loan size of 50K DM;
- 10,300,000 DM disbursed;
- arrearage rate under 10% and classified loans under 10%;
- 2,060 jobs created (assumes one job per 5,000 DM); and
- 15MM DM in deposits gathered.

**Year Two**

- 420 loans disbursed with average loan size of 85K DM;
- 36,200,000 disbursed;
- arrearage rate under 10% and classified loans under 10%;
- 7,240 jobs created; and
- 34 MM DM in deposits gathered.

**Year Three**

- 502 loans disbursed with average loan size of 106K DM;
- 52,505,000 DM disbursed;
- arrearage rate under 5% and classified loans under 10%;
- 10,500 jobs created; and
- 53 MM DM in deposits gathered.

For the period of performance, anticipated results are in aggregate:

- 1,122 loans disbursed
- 99,005,000 DM disbursed (includes reflows - estimated loan life is one year)
- 19,800 jobs created
- 102MM DM in deposits gathered

**Benchmarks**

Within 30 days:

- A comprehensive work plan to be approved by USAID
- Develop a comprehensive set of oversight procedures
- Apply for a lending license
- Establish and staff the Loan Unit office

Within 60 days:

- Establish a budget and projected revenues.
- Establish framework operating procedures such as will ensure prudent operations
- Provide USAID with a comprehensive design for the establishment of a full service banking institution; including a detailed plan describing the proposed fiduciary responsibilities of the commercial banking institution towards USAID after the completion of the initial three year program implementation period.

Within 90 days

- Complete a database of Kosovar companies with financial data and credit requirements
- Commence training of Kosovar staff in SME lending practices
- Draft operational structure, credit policies and procedures, loan follow-up and recovery policies, accounting systems, loan and

collateral documentation, and oversight and audit functions established Lending Unit to become licensed and formally open Staff fully trained

- A minimum of 50 business plans and loan applications prepared

Within 120 days:

- Establish a contractual agreement with that entity ensuring proper representation, reporting and commitment to adhere to prudent lending activities as well as continue the activities of the Lending Unit
- In conjunction with USAID, determine a partner bank/institution to form the business bank

Within 150 days:

- The banking institution is provided an operating license

Within 180 days/6 months:

- Commence deposit gathering activities
- 50 loans booked
- 2,000,000 DM disbursed
- 400 jobs created (cumulative)

Within 270 days:

- Deposit gathering - DM 9,000,000
- 120 loans booked (cumulative)
- 5,500,000 DM disbursed (cumulative)
- 1100 jobs created
- Provide funding of a commercial banking partner institution

Within 360 days/1 year:

- Deposit gathering - DM 15,000,000
- 200 loans booked
- 10,300,000 DM disbursed
- 2,060 jobs created

Within 720 days/2 years:

- 620 loans booked
- 46,500,000 DM disbursed
- 9,300 jobs created
- 49,000,000 DM in deposits gathered
- Loan window operation fully integrated into the operation of the commercial banking partner institution

Within 1080 days/3 years:

- 1,122 loans disbursed
- 99,005,000 DM disbursed (includes reflows - estimated loan life is one year)
- 19,800 jobs created
- 102,000,000 DM in deposits gathered
- A detailed plan describing USAID's ongoing monitoring and oversight role in the operation of the commercial banking institution after the completion of the three year program implementation period.

